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Slowdown? Not So Fast!

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Misplaced fears of an economic slowdown increase the risk that inflation will speed up.

As the bond market takes the bit in its teeth and pushes the **10-year Treasury** yield to new two-month lows near 4.2%, **gold** today is also chalking up one of its best days since February, rallying more than $5 to back above $430 for the first time since March 22, when the **FOMC** first acknowledged current inflation reality. But the bond rally and gold pop, of course, are signaling two completely different things, to wit: if the bond market is right and fears of a growth pause constrain **the Fed's** policy-normalization program, then gold is signaling that the inflation pressures that are already evident will only be exacerbated.

Although it's never a riskless proposition to assume that the Fed will take a clear-eyed view of the economic landscape, the notion that the expansion is now braking sharply enough to significantly alter the Fed's course appears far-fetched. For one thing, even after 175 basis points in rate hikes, monetary policy remains accommodative. Relative to the current 12-month **core CPI** rate of about 2.3%, at 2.75% the real **fed funds** rate has barely breached positive territory. To suggest, as a growing chorus of commentators are, that the Fed's rate hikes to this point have hurt growth is ludicrous. The real rate averaged close to 3% during the late 1990s.

That also underscores the risk implied by the rising clamor for the Fed to cut short this rate normalization cycle. The ultra-low real rate is one measure demonstrating that policy remains unquestionably easy, and the longer the Fed maintains that posture, the greater will be the eventual inflationary outcome. As it is, the uptick in inflation has become difficult to miss. Today's subdued reading on **core PPI** -- up just 0.1% -- helped support the bid for bonds, but one month's data in such a notoriously volatile series hardly counts as a trend. Over the past six months, core PPI is up more than 3% at an annual rate, more than double its six-month rate of a year ago.

In retailing the slowdown story, some bastions of conventional economic wisdom are also obsessing over the "miniscule" so-called **savings rate**, an archaic measure of current consumption relative to current income, on the theory that households will have to cut consumption to rebuild savings. A more relevant measure of income relative to wealth, however, suggests such concerns are badly misplaced. At about 5.3, the ratio of **household net worth to disposable income** has returned to levels seen at the outset of the late-1990s economic boom. From this perspective, consumption growth can be seen as an indication of confidence that recent wealth gains will be sustained, rather than as a spurt of overindulgence sure to be short-circuited once "the consumer" returns to his senses.

Confidence in the sustainability of the expansion is also seen in the renewed leadership role of business fixed investment. **Equipment and software investment**, growing at about 14.5% year-on-year as of fourth quarter '04, was back to late-1990s levels. More recent monthly data shows new orders for **non-defense capital goods excluding aircraft** -- a proxy for fixed

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investment -- rising at an annual rate of more that 14% the past three months. Such investment growth indicates that expected returns to capital remain robust, which is not usually a recipe for significant economic deceleration. It's true that the late '90s investment boom went bust in fairly rapid fashion at the turn of the decade. But that was attributable mostly to the deflationary liquidity squeeze engineered by the Fed to rein in what is saw as runaway growth in investment and financial asset values. Obviously, such a deflationary policy stance is nowhere in evidence today.

One wild card in the current environment is the **oil** price situation, which presents what **Alan Greenspan** might term a particular "conundrum" for the Fed. To the extent escalating oil prices create a drag on expansion, the Fed's natural inclination -- under the guise of macro demand-management -- would be to offset it by raising rates less than it otherwise would, all things equal. Greenspan is well aware, however, that accommodating spiking oil prices with easy money was the indispensable ingredient in the recipe for the inflation outbreak of the 1970s. Although the crude price has fallen more than $5 from its peak earlier this month, at above $50 it remains a source of both growth and inflation risk. Historically, the Fed has not shown itself adept at handling such a delicate balance of risks, but Greenspan is now in the last year of his long service at the central bank and would figure to be motivated to avoid having his legacy besmirched by sanctioning a significant inflation breakout as his last act in office.

Bottom Line: The bond market has taken off on its latest rally on the notion that a supposedly weaker economy will compromise the Fed's rate-normalization program. But we reject the notion that the economy is slowing significantly. Absent major growth risk, we doubt the Fed's course will be altered by only trivial signs of slowdown, and dispute the idea that the best option would be for the Fed to call an early end to this rate cycle. Inevitably, that would entail even more inflation than is already feeding through the system, and ultimately result in sharply higher rates, which would almost assuredly put the expansion at risk. The Fed also faces a delicate task in responding to the escalating oil price, but should limit the inflationary consequences provided it remains on a steady rate-normalization course. TM